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TAGS: CA ECON EFIN ENRG EPET ETRD
SUBJECT: PSYCHOLOGY, REALITY AND INTEGRATION: CANADA'S
ECONOMIC HEALTH WILL NOT PROTECT IT FROM THE GLOBAL DOWNTURN

REF: A. TORONTO 322
¶B. TORONTO 327
¶C. OTTAWA 1362

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¶1. (SBU) Summary: How Canada fares in the global economic crisis will be measured as much by its integration with the U.S. economy as by Canada's own domestic economic policies. The bottom line is: Canada's solid economic policy management will only serve to mitigate the impact of the global financial crisis and the United States, economic difficulties. Canada,s deep economic integration with the United States will cause Canada to suffer as much or potentially more than many of our other large trading partners, if the U.S. economy enters a prolonged recession. Of course it could conceivably be hurt less if the United States in turn suffers less economic hardship than other countries or pulls out of its economic downturn. End summary.

¶2. (SBU) Canada's macroeconomic indicators are largely healthy (the global financial crisis aside) and this country's history of cautious, highly-regulated financial operations, now looks "prescient" rather than "outmoded." Canada,s October year-on-year inflation rate is 2.2 percent; its 6.1 percent unemployment rate is at historically low levels (with every province suffering from skilled labor shortages); and the federal government has enjoyed a budget surplus each year since 1998. The relative drop in the Canadian dollar (down 25 percent against the USD since the beginning of the year) should boost Canada's manufactured exports, though revenues from priced-in-USD energy have dropped significantly and Canada,s balanced budget also provides a macroeconomic cushion. Nevertheless, Canada's deep integration with the United States leaves Canada vulnerable to our economic and financial downturn. These facts are not the only negatives spilling across this long border; the drop in confidence among Americans is leading a gloomy cold front that is seriously dampening consumer confidence and thus markets in Canada. One example: the drop in the Toronto Stock Exchange aggregate since January 2 and again since September 15, which parallels the fall in the Dow Jones over the same period. The bottom line is: Canada's solid economic policy management will at best only serve to mitigate the impact of the financial crisis, and its proximity to and interrelationships with the U.S. will cause it to suffer as much or potentially more than many of our

large trading partners.

¶3. (SBU) In recent days, we have been talking with a number of well-placed economic actors ranging from the Deputy Minister of Finance to Canada's G-8 sous-sherpa to the chief economist of the Royal Bank of Canada (RBC), and their staffs, for a picture of what the Canadian economy is facing. We've been helped by excellent formal and informal reporting from our Consulates. What follows is a summary of the consolidated picture of the Canadian macroeconomic situation and its vulnerabilities.

Canadian banking system healthy but still worried -- housing market cooling
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¶4. (SBU) Canada's banks and investment brokerages have been
Q4. (SBU) Canada's banks and investment brokerages have been
operating for years in a much more conservative regulatory environment than their U.S. counterparts. Among a host of different reserve and capital base requirements, Canada never separated investment banks from retail banking operations in Canada and thus all brokerages are part of the financial empires controlled by Canada's five major retail banks. This means that even investment/brokerage operations must meet the regulatory requirements pertaining to retail banking operations. The aggregate leverage of Canadian banks is markedly smaller than the levels now extant in the United States and there is only a small sub-prime mortgage component. Additionally, the collapse of the asset-backed commercial paper market last year forced Canadian banks to recognize and deal with certain problematic asset categories.

The World Economic Forum recently ranked Canada's banking sector as the world's healthiest. Yet this will only insulate Canada up to a point. Given the interrelationship of financial markets across the border, the tightness of credit flows in the United States is having a measurable impact on Canadian lending, especially within the tighter capital adequacy ratio requirements that Canadian institutions must meet. In terms of housing market lending, Canada is not facing a homegrown mortgage crisis -- the consumer housing market remains relatively strong compared to the United States, but consumer confidence is causing a dip in purchases and housing starts. There are local housing bubbles (in Vancouver, parts of Ottawa, and Montreal), but very little of this effect is related to sub-prime mortgages, rather to rapidly escalating property values. In addition, the mortgages at risk are a very small percentage of the loans held by the big five national banks. As the RBC chief economist noted, "we are facing a cooling rather than a collapse of our housing sector."

Canadians will maintain their balanced-budget religion; see their credit actions as "maintaining a level playing field"
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¶5. (SBU) It has been a shibboleth of Canadian pol-econ policy since the mid-1990s (when Canadian Federal deficits ballooned) that Canada must maintain balanced Federal budgets. This is a political red-line that will only be crossed in extremis, and no one here thinks that type of crisis is near. In Keynesian terms, this limits the ability of Ottawa to prime the pump during economic downturns. Some economists have explained to us, however, that they have enough positive headroom within their budget and off-budget accounts to try and jumpstart and/or mitigate any approaching downturn in the economy by increasing spending without actually going into deficit. At the same time, the Federal and some Provincial governments are taking measures to ease the credit crunch here. Finance Minister Flaherty announced on October 23 a range of actions, including purchases of up to C$25 billion of insured mortgages and expanding insurance coverage by the Canadian Lenders Assurance Facility. In addition, the British Columbia provincial government on

October 24 outlined a 10-point program of tax cuts, budget cuts and capital outlays to help insulate the province, and the BC Premier is recalling the provincial Parliament to vote on this legislation. In Ontario, Canada,s manufacturing heartland and economic center of gravity, a province that has been hit hard by the high Canadian dollar over the past year and declining consumer demand in the U.S., the Premier recently announced a deficit provincial budget (see ref B), the first since 2005.

Volatility and regional differences in growth complicate Federal economic and energy policy
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¶6. (SBU) As a corporate chief economist told us this week, "it is the volatility of both exchange rates and energy prices that is killing us, not the actual levels of either." Several of our contacts have opined that an exchange rate of QSeveral of our contacts have opined that an exchange rate of US 80-85 cents to C$ 1 is probably the long-term purchasing-power parity level and the level that balances Canada's export engine with its import needs. Yet the movements from US 95 cents to US 80 cents to the C$ during the last two months (and from US 1.10 a year ago) are making decisions, predictions, and hedging very difficult. The rise of the US$ is also introducing a sardonic factor -- a senior bank economist told EMIN that "you guys have the best of both worlds; you can tank the world economy and then increase your currency's strength as it serves as a store of value when problems become global."

¶7. (SBU) Another area of uncertainty for policymakers is the large differences in economic performance across the provinces. Many of the western provinces (BC, Alberta and Saskatchewan) with a largely resource extraction economic base call themselves the "have" provinces with high employment rates and healthy bottom lines, while Ontario, Quebec and Atlantic Canada are suffering from the demise of

the manufacturing sector. In fact, the huge demand for labor in the energy bubbles of Alberta and Saskatchewan have eased unemployment in Canada,s eastern provinces.

¶8. (SBU) Canada faces a complicated nexus between exchange rates, trade, and energy prices at the best of times. A major contributor to the value of the Canadian dollar is the price of oil, as Canada is a major oil exporter, supplying the United States with 17 percent of our oil needs. In particular, the capital and labor-intensive oil sands sector in Alberta is watching oil prices and exchange rates closely; there is a fair amount of disagreement here about the "break-even level" below which continued extraction would be unprofitable. Yet trade for Canada is a major national engine of growth and the lower exchange rate will have a positive effect (as long as domestic and U.S. demand keep up) on manufacturers, who have taken a hammering over the last five years due in part to the rising C$.

¶9. (SBU) We defer to CG Calgary, but pass on that the emerging consensus position in Ottawa is that technology developments and growing productivity levels are lowering the oil market break-even point to somewhere in the US$ 50 per barrel range. Yet while Ottawa policy makers may be talking about the break-even point for oil sands production, that figure is actually less relevant, since producers must only cover their variable costs to make continued production worthwhile. A number of factors suggest they will continue to do so. The general slowdown in the U.S. and Canadian economies may work to lower some costs, especially labor, and the flip in exchange rates may support continued production and export. In-country costs are in C$, while export revenues are in US$, making it that much cheaper to meet those costs. While Canada does import energy from the United States, imports are much smaller than exports. On the whole, Canada,s energy sector is probably benefiting from the

reversal of exchange rates.

¶10. (SBU) The situation with capital investment is different, however. Imported material costs are higher in C$ terms, and financing decisions may be different (balance sheet vs. credit). Even though oil companies are normally very conservative on price forecasts made in support of investment decisions, we are seeing companies slow down major projects, which also eases pressure on material and labor markets.

Consumer and corporate psychology a key factor
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¶11. (SBU) One of the main factors that will determine how Canada rides out the United States, perfect economic and financial storm is psychological. The interrelationship between our two real economies is so massive as to tie Canada largely to developments in the United States no matter what their policy choices; but industrial and consumer gloom could lead to a self-fulfilling prophecy in both countries. There has been over the last decade "less excess" in consumer spending and indebtedness in Canada than in the United States, and thus less vulnerability. But Canadians have long experience with having the U.S. economic dog wagging their Qexperience with having the U.S. economic dog wagging their northern tail, and they are already slowing down their purchasing and borrowing levels in a manner which will, like a vicious circle, contribute to their own national slowdown. Businesses will focus on cutting costs and jobs in preparation for what they fear will be a deflationary spiral. Credit is not as tight here as in the States, and the housing markets are healthier, but the exposure of Canadian citizens, firms, and banks to the U.S. markets writ large (and not to mention to American media and to our overall economic zeitgeist) will have a major impact both on reality and in psychological terms.

¶12. (SBU) For those reasons, it is perhaps not a surprise that the Canadian Government is very supportive of the Administration's coordination over recent weeks with the G-7 and now with the G-20 on a global approach to the global crisis. Senior Canadians are participating actively in these discussions and have praised the speed and "multilateral nature" of the USG response so far.

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